

The HFSB Standards

Introduction

HFWG/HFSB

Although the Standards set out below have been formulated by the HFWG, they refer to HFSB because from now on the “ownership” of the Standards will rest with that organisation.

How to read the Standards

The Standards are set out in a consistent format in blue shaded boxes throughout this document. The differentiated formatting of the text within the boxes reflects the different nature of the content:

- The actual Standards (**in bold**)
- Additional guidance and examples which are intended to assist and illustrate how compliance might be achieved (in normal text)
- Explanations and comments (*in italics*).

Illustration

- **The actual Standard is set out in bold text**
 - **Lists of relevant sub-items which form part of the Standard are set out in bold text.**

Guidance on the Standard (and references to useful additional guidance, eg materials published by AIMA and IOSCO) and examples of how the Standard might be complied with are set out in normal text.

Additional explanation and commentary to enhance understanding is set out in italics.

It is the Standards (in bold type) to which hedge fund manager signatories to the Standards are required to conform on a comply or explain basis. The guidance and examples (in normal and italic type) are intended only to assist managers in complying with the Standards.

Applicability of the Standards to particular types of management activity

We should emphasise that the Standards have been designed so as to apply to fund managers solely in respect of their management activities in relation to hedge funds for which they act as the investment manager. They do not apply to other activities including, by way of example, management activities in relation to segregated accounts or fund of hedge funds although certain of the Standards might, with or without adaptation, be appropriate for hedge fund managers to utilise in carrying out those other activities.

We would have no objection if a hedge fund manager, for the avoidance of any doubt, specified in its Disclosure Statement and on its website any areas of its business to which the Standards are not applicable.

In circumstances where a manager carries out sub-advisory functions for a manager of a hedge fund or is appointed by the operator of a fund platform to manage a particular pool of assets, it is recognised that the manager's position vis-à-vis the fund governing body is likely to be less influential than is the case in a typical hedge fund structure where the manager is the directly appointed investment manager. Nevertheless, inasmuch as a particular Standard requires the manager to do what it reasonably can to enable the fund governing body

to achieve a particular outcome and in relation to any Standards which it is not authorised or able to conform with given the terms of its appointment or mandate, then the manager should still be able to comply with that Standard if, in practice, it encourages the relevant pool operator or manager itself to adopt the Standards.

Certain of the Standards may also be capable of application to other areas of the asset management industry. If participants in those areas find any of the Standards helpful and wish to adopt or adapt them for their circumstances then they are of course free to do so and we would welcome that.

Applicability to smaller managers

The HFWG encourages broad adoption of the Standards by fund managers involved in hedge fund management irrespective of their size and the stage of development of their firms. Although fund managers who founded the HFWG may be considered more “established”, each having more than US\$4 billion under management, the Standards are equally capable of being adopted by smaller as well as larger firms.

During the consultation, some felt that established managers may find it easier at the outset to comply or take steps to achieve compliance or otherwise explain their approach than a smaller manager or start-up. A smaller manager could, for example, face resource constraints in producing more detailed documentation to explain its approach to investors on broader comply or explain issues.

The HFWG has noted this concern and has added acknowledgements in some Standards which take account of specific challenges facing smaller managers. Moreover, an explanation from a manager as to why it is unable to comply with a particular Standard may be considered entirely appropriate in the circumstances.

Disclosure in the fund's offering documents

Various of the Standards require a manager to do what it reasonably can to enable and encourage the fund governing body to make certain disclosures in the fund's offering documents. For the avoidance of doubt, HFSB expects this to apply only to current and future offering documents. To the extent that a fund's current offering documents do not contain the required disclosure, we would expect managers to do what they reasonably can to enable and encourage fund governing bodies to update such offering documents to include the relevant disclosures as soon as practicable in order to comply with the relevant Standard.

However, a manager may of course choose to not comply with such Standard but rather to explain that, for example, on the grounds of cost, it intends to encourage the fund governing body to wait until the fund's offering documents are next updated for some other reason. So far as old offering documents are concerned where there is no outstanding offer of securities being made, a manager can effectively ignore the Standards relating to offering document disclosure since the relevant offer closed before the Standards had been adopted.

Disclosure in the manager's own marketing materials

Various of the Standards require a manager to make certain disclosures in its “marketing materials”. In recognition of the fact that a manager's marketing materials will normally comprise various documents, sometimes including very short “teasers” or “flyers”, the Standards should not be interpreted as requiring the same information to be included in each such document. Rather, such documents should when taken as a whole, and together with the fund's offering documents, contain the required disclosures and it is for the manager to decide which disclosures ought properly to be made in which documents with a view to ensuring that investors and prospective investors are provided with the information they would reasonably require in

order to make a properly informed investment decision. It follows that where in the Standards a disclosure is required in the manager's marketing materials this requirement will be met if disclosure is made in the fund's offering documents.

FSA Principles

The FSA Principles relevant to each of the Standards are set out within the Standards. It should be noted that for UK regulatory purposes the references in the FSA's Principles to a firm's "customer" or "client" are in this context to be read as a reference to the fund managed by the manager and not to the investors in the fund. Nevertheless, HFSB believes that managers will wish to consider the interests of the investors in the funds and to do what they reasonably can with a view to ensuring that the benefits of outcomes sought by the Standards flow through to investors.

Disclosure to investors and counterparties [1]-[4]

There are several areas where adequate disclosure is required:

- Investment policy and associated risks, which relates to disclosure to investors of the fund's investment strategy and the risks involved in an investment in the fund (Standard [1])
- Commercial policy, which relates to disclosure of the commercial terms on which the manager has agreed to manage the fund and on which investors will invest (Standard [2])
- Performance measurement (Standard [3])
- Counterparty disclosures, such as to prime brokers (Standard [4]).

Investment policy and risk disclosure [1]

Investment policies and strategies and related risks can vary significantly between funds. Ensuring that these are carefully explained in a fund's offering documents or the hedge fund manager's own marketing materials is therefore vital to enable investors to make well-informed decisions when investing and monitoring investments. The HFWG identified the following issues on investment policy disclosure:

- Do hedge fund managers provide sufficient information to investors as to the investment policies, strategies and the potential risks associated with the strategies and techniques used to generate returns?
- Do hedge fund managers adhere to any standard guidelines for reporting on investment policy?

FSA Principles

Relevant FSA Principles include:

- (6) Customers' interests – a firm must pay due regard to the interests of its customers and treat them fairly.
- (7) Communication with clients – a firm must pay due regard to the information needs of its clients and communicate with them in a way which is clear, fair and not misleading.

Investment policy and risk disclosure - Standards and Guidance [1]¹⁰

- **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to include an appropriate level of disclosure (taking into account the identity and sophistication of potential investors) and explanation in the fund's offering documents of the fund's investment policy/strategy and associated risks.**

HFSB envisages that in most circumstances such disclosure would, amongst other things, include:

- an appropriate description of the investment strategies and techniques employed and prominent disclosure of the risks involved (Standards [16], [18], [20] and [22] also deal with risk disclosure);
- general details of the investments and instruments (including, for example, derivatives) likely to be included in the fund's portfolio;

¹⁰ In conforming to these best practice standards, managers may wish to consult the guidance contained in MFA Sound Practices for Hedge Fund Managers (2007) (eg 2.2, 2.3, 2.4, 2.5) as well as the CFA Institute's Asset Manager Code of Conduct – Selection F (Disclosure) and AIMA's Guide to Sound Practices for European Hedge Fund Managers (2007).

- details of any investment restrictions or guidelines and of the procedures the manager will follow in respect of any breaches;
- an explanation of the circumstances in which the fund may use leverage, the sources of such leverage and details of any restrictions on the use of leverage; and
- prominent disclosure of the risks involved in employing leverage.

- **A hedge fund manager should ensure that its own marketing materials refer to the fund's offering documents and make it clear that investors should rely only on the fund's offering documents when making any decision to invest.**

It is recognised that incidental image or other short form marketing materials may not include such a cross reference to the fund's offering documents.

- **A hedge fund manager should carefully consider the appropriate mechanism, given the nature of potential investors, for changing the fund's stated investment policy/strategy and advise the fund governing body accordingly. This may range from prior investor/fund governing body consent, to consultation to mere notification. Once the fund governing body has determined the appropriate mechanism, the manager should do what it reasonably can to enable and encourage the fund governing body to disclose such mechanism appropriately in the fund's offering documents.**
- **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to include in the fund's annual report a statement explaining how the fund has invested its assets during the relevant period in accordance with its published investment policy.**

HFSB envisages that such statement will comprise a high-level factual explanation as to how the fund has invested its assets during the period. It is not intended to be a review or confirmation of compliance with the fund's investment policy.

Commercial terms disclosure [2]

The commercial terms of hedge funds are very important to investors. The terms include, for example, management and performance fees, expenses, minimum “lock-up” periods during which an investor is unable to exit its investment, redemption notice periods, redemption penalties and any powers to defer redemptions. Adequate disclosure is therefore necessary to enable investors to make well-informed investment decisions.

The HFWG identified the following issues on disclosure of commercial terms:

- Do hedge fund managers provide adequate disclosure to investors about the commercial terms applicable to an investment in their funds?
- Are any changes to such commercial terms adequately disclosed to investors?

FSA Principles

Relevant FSA Principles include:

- (1) Integrity – a firm must conduct its business with integrity.
- (6) Customers’ interests – a firm must pay due regard to the interests of its customers and treat them fairly.
- (7) Communications with clients – a firm must pay due regard to the information needs of its clients, and communicate information in way which is clear, fair and not misleading.
- (8) Conflicts of interest – a firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.

Commercial terms disclosure – Standards and Guidance [2]¹¹

- **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to disclose the commercial terms applicable to a particular hedge fund in sufficient detail and with sufficient prominence (taking into account the identity and sophistication of potential investors) in the fund's offering documents.**

HFSB envisages that in most circumstances such disclosure would, amongst other things, include:

- fees and expenses:
 - fair disclosure of the methodology used to calculate performance fees;
 - details of any other remuneration received by the manager in connection with its management of the fund (this will be relevant, for example, where a hedge fund is a “feeder” fund into another fund managed by the same manager);
 - the basis of calculation for any base management fee and details of the nature of any expenses which may be payable or reimbursed by the fund to the manager;
 - to the extent possible, the amount of and/or method of calculating the periodic fees payable to the fund’s other service providers; and
 - if applicable, the fact that the fees and expenses payable to service providers may change

¹¹ Managers may wish to consult further guidance, as set out by MFA’s Sound Practices for Hedge Fund Managers (2007) (2.6) and GIPS guidance on disclosure of fees and cost (section F), <http://www.gipsstandards.org>.

- termination rights:
 - details of the circumstances in which the fund is entitled to terminate the manager's appointment and the terms (eg in relation to termination fees) of such termination.
- exit terms (in the case of open-ended funds):
 - the period of notice investors are required to give to redeem their investment in the fund;
 - details of any redemption penalties;
 - any "lock-up" periods during which the investor will be unable to redeem its investment in the fund and any limits on the extent of redemptions on any redemption date (i.e. redemption "gates"); and
 - the period of notice investors are required to give to redeem their investment in the fund;
 - details of any redemption penalties;
 - any "lock-up" periods during which the investor will be unable to redeem its investment in the fund and any limits on the extent of redemptions on any redemption date (i.e. redemption "gates"); and
 - circumstances in which normal redemption mechanics might not apply or may be suspended, if any.

- **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to disclose any material changes to such commercial terms to investors.**
- **A hedge fund manager should disclose the existence of side letters which contain "material terms"¹², and the nature of such terms. A hedge fund manager is not required to disclose the existence of side letters which contain no material terms.**

Further guidance on this Standard is contained in AIMA's Industry Guidance Note on Side Letters.¹³

- **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to disclose in the fund's financial statements the management and performance fees charged. This includes explanations in the annual report which allow investors to compare, readily, the fees charged with the description of such fees set out in the fund's offering documents where this is not obvious from the disclosure in the financial statements.**

For example, the categories and captions in the fund's financial statements might correspond to those used in the fund's offering documents so they can be easily compared.

Managers might also consider disclosure of a total expense ratio (TER) or gross vs. net return for the period under review.

- **On the establishment of a fund, a hedge fund manager should liaise with the fund's administrator to ensure that the methodology for calculating fees payable to the manager (and in particular performance fees) is agreed in advance. A hedge fund manager should also do what it reasonably can to enable and encourage the fund governing body to ensure that such methodology is accurately described in the fund's offering documents.**

12 "Any term the effect of which might reasonably be expected to be to provide an investor with more favourable treatment than other holders of the same class of share or interest which enhances that investor's ability either (i) to redeem shares or interests of that class or (ii) to make a determination as to whether to redeem shares or interests of that class, and which in either case might, therefore, reasonably be expected to put other holders of shares or interests of that class who are in the same position at a material disadvantage in connection with the exercise of their redemptions rights." AIMA's Industry Guidance Note on Side Letters and Supplement No. 1 thereto: <http://www.aima.org/uploads/AIMAIndustryguidanceNoteSideLettersMembers.pdf>

13 AIMA's Industry Guidance Note on Side Letters and Supplement No. 1 thereto: <http://www.aima.org/uploads/AIMAIndustryguidanceNoteSideLettersMembers.pdf>

Performance measurement [3]

Accurate and consistent reporting of investment performance enables investors to make well-informed judgments about their investments and allows them to compare different managers and hold them to account. The Global Investment Performance Standards (GIPS)¹⁴ provide a standardised approach to performance presentation to communicate investment results to clients and prospective clients. It is widely used among traditional asset managers and specific standards have recently been developed with specific applications to private equity. The existing standards are under review to include guidance to the hedge fund sector.

The HFWG identified the following issue:

- Do hedge fund managers inform their clients in an adequate manner about performance?

FSA Principles

Relevant FSA Principles include:

- (6) Customers' interests – a firm must pay due regard to the interests of its customers and treat them fairly.
- (7) Communication with clients – a firm must pay due regard to the information needs of its clients and communicate with them in a way which is clear, fair and not misleading.

Performance measurement - Standards and Guidance [3]

- **A hedge fund manager should, in cases where, in its view, the fund has material exposure to hard-to-value assets, ensure that any disclosure in its own marketing materials relating to the fund's performance is accompanied by a reference to any factors which may be material to the robustness of the performance calculation. A hedge fund manager should also do what it reasonably can to enable and encourage the fund governing body to include similar references in the fund's offering documents where they include details of the fund's performance.**

Such factors might, amongst others, include:

- the percentage of the portfolio invested in what the manager considers to be hard-to-value assets;
- the method used in valuing assets which the manager considers to be hard-to-value; and
- the use of side pockets.

HFSB welcomes the initiative of GIPS to review the applicability of their existing principles to hedge funds.

14. Administered by CFA Institute (www.gipsstandards.org).

Disclosure to lenders/prime brokers/dealers [4]

Hedge fund managers rely on commercial and investment banks and other financing counterparties to provide extensions of credit and other forms of lending. Financing to hedge funds has evolved in a variety of ways from traditional prime brokerage vehicles (margin lending and stock borrowing) to synthetic and derivative instruments, and more recently to guaranteed, fixed and long-term facilities. The type of credit extended to hedge funds depends on a host of variables which the fund and the manager determine between them.

The amount of credit risk that counterparties will assume will be a function of the bilateral agreement with the hedge fund, in particular the collateralisation of positions. To assess the credit risk, counterparties will require information about the hedge fund and its positions.

It is normal for lenders to take responsibility for demanding satisfactory levels of transparency to enable them to make well-informed lending decisions. Supervisors and others have suggested that the provision of such information by hedge funds can be impeded inter alia by insufficient protection of the confidentiality of that information within the lending institution. It is therefore essential that hedge fund managers recognise the importance of addressing any potential conflicts with the lender so that the lender can receive the necessary flow of information to make well-judged lending decisions.

For these reasons, the Counterparty Risk Management Policy Group II (CRMPG II) has recommended disclosure practices to improve transparency and counterparty credit assessments.¹⁵ CRMPG II stated that, when determining how much information to provide on a confidential basis to their counterparties, market participants should recognise that provision of relevant credit data increases the level of counterparties' comfort and improves the likelihood that access to credit will continue during periods of systemic and institutional stress. The HFWG endorses the breadth and direction of these recommended practices.

The HFWG identified the following issues in relation to disclosure to lenders:

- Are conflicts of interest between lenders and hedge funds identified?
- Do hedge fund managers provide lenders with sufficient information to assess risk adequately?

FSA Principles

- (1) Integrity – a firm must conduct its business with integrity.
- (2) Financial prudence – a firm must maintain adequate financial resources.

Disclosure to lenders/prime brokers/dealers – Standards and Guidance [4]

- **A hedge fund manager should, subject to obtaining the consent of the fund's governing body, provide, or do what it reasonably can to enable and encourage the fund's administrator to provide, any agreed information reports to the fund's counterparties in a timely manner.**

¹⁵ Counterparty Risk Management Policy Group II (2005), *Towards Greater Financial Stability: A Private Sector Perspective* (2005), section III (Improving Transparency and Counterparty Credit Assessments), p. 46, <http://www.crmgroup.org>.

Valuation [5]-[9]

Valuation is the process of determining the value of a hedge fund's portfolio at a given time. While valuation is generally expressed as a single number it is important to recognise that the single number is merely the expression of a range of potential outcomes that derive from the valuation process. It follows that investors need to be informed about the valuation process and have confidence in its breadth and robustness. For example, the valuation process should be seen in the context of the depth of the market in the relevant asset class. As hedge funds are significant users of complex assets, where depth of markets may be uncertain, this needs to be borne in mind when considering valuations of those underlying assets.

The liquidity crisis

The credit crunch which began in summer 2007 has demonstrated that the valuation of hard-to-value assets is clearly one of the most significant issues affecting confidence in the financial industry today. We hope that the Standards we have drawn up for hedge funds will contribute to best practice in this area. But the issues apply to the whole financial services industry. The inherent problem is the inadequacy of any single number to answer the question of what an asset is worth, what could it be sold for, over what period etc. This is one of the most pressing areas on which progress is needed in the months ahead and it is just as pressing for investment banking, proprietary trading desks, commercial banks and money market funds. The hedge fund sector stands ready to play its part in this debate, which needs practitioners, lenders, third parties, investors and the accountancy profession to come together if progress towards better understanding and better transparency and portrayal of valuations is to be made.

For open-ended funds, the valuation is the basis for subscriptions to and redemptions from hedge funds by investors. For all hedge funds, it measures the hedge fund's performance and affects the compensation of the hedge fund manager. Here, we identify two sets of issues in relation to valuation: segregation of the valuation and portfolio management functions and how to deal with hard-to-value assets.¹⁶

¹⁶ High quality materials on valuation principles have also been created by others, including AIMA and IOSCO. AIMA's Guide to Sound Practices for Hedge Fund Valuation and IOSCO's Principles for the Valuation of Hedge Fund Portfolios (2007) provide further detail on specific valuation themes. The HFWG recommends both as further guidance for hedge fund managers in formulating their valuation approach.
Links: <http://aima.org/uploads/execsummaryAIMAGuidesSPforHFValuation2007.pdf> (the full text is only available in hard copy),
<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD240.pdf>

Segregation of functions in valuation – Governance [5]+[6]

For some hedge funds, a third party will be responsible for valuing the fund's assets and calculating the fees payable to the manager. However, this formal segregation of duties can be compromised if the manager has a significant input into and/or influence over the valuation process. Such an outcome is particularly likely where a hedge fund invests in hard-to-value assets or complex derivatives and the third party lacks sufficient expertise in that area.

By contrast, other hedge funds have valuations performed by specialist in-house functions. Reasons for doing so include the timeliness of the valuation process, the complexity of the assets and investments in the fund's portfolio or other commercial considerations. However, such recourse to in-house specialist functions increases the risk of conflicts.

Since in either case it is possible for the hedge fund manager to exercise influence over the valuation process, potential conflicts of interests between the hedge fund manager and investors could arise. It is therefore vital that such potential conflicts of interest are adequately managed.

The HFWG identified the following issues concerning the separation of responsibility for valuing a fund's assets from the portfolio management function:

- Do hedge fund managers adequately mitigate potential conflicts of interest when they are involved in assisting third parties in valuing the fund's assets or when valuations are performed in-house?
- Do investors understand how the valuation process is conducted?
- Are sufficient safeguards in place to ensure that valuation policies are applied consistently?

FSA Principles

Relevant FSA Principles include:

- (1) Integrity – a firm must conduct its business with integrity.
- (2) Skill, care and diligence – a firm must conduct its business with due skill, care and diligence.
- (3) Management and control – a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
- (6) Customers' interests – a firm must pay due regard to the interests of its customers and treat them fairly.
- (7) Communications with clients – a firm must pay due regard to the information needs of its clients, and communicate with them in a way which is clear, fair and not misleading.

Segregation of functions in valuation – Governance Standards and Guidance [5]

- **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to put in place valuation arrangements aimed at addressing and mitigating conflicts of interest in relation to asset valuation.**

HFSB believes that the most satisfactory way to achieve this is for a hedge fund manager to do what it reasonably can to enable the fund governing body to appoint an independent and competent third party valuation service provider.

HFSB acknowledges, however, that in some cases it will not be possible in practice to achieve both independence and the required level of competence by appointing a third party valuation service provider, in which case the involvement of the hedge fund manager in the asset valuation process will, to a greater or lesser extent, be unavoidable.

- **Where a hedge fund manager determines the value of any of the fund's assets (whether by performing valuations in-house or providing final prices to a valuation service provider), it should operate a valuation function which is segregated from the portfolio management function and should explain its approach to investors. If a smaller or start-up manager considers it impractical to do so, it should disclose this in its marketing documents and do what it reasonably can to enable and encourage the fund governing body to disclose this in the fund's offering documents.**

It is envisaged that this will, amongst other things, entail:

- ensuring that the relevant employees operate independently of the portfolio management team and that potential conflicts of interest are minimised;
- ensuring that the remuneration of the valuation team is not directly linked to fund performance;
- in instances where the portfolio management team has necessary expertise and understanding, ensure that information provided by that team in connection with the valuation process is properly documented and recorded; and
- assisting fund governing bodies to satisfy themselves regularly that in-house valuations are handled appropriately.

Ways to achieve this might include:

- ensuring that valuation staff provide a report on the valuation process periodically to the fund governing body;
- doing what it reasonably can to encourage the fund governing body to form a designated “valuation committee” (no member of which is involved in investment decisions); and
- employing the services of an appropriate external party to evaluate the effectiveness and robustness of the valuation procedures in place and report to the fund governing body (or its valuation committee).

Hedge fund managers should refer to AIMA's Guide to Sound Practices for Hedge Fund Valuation (2007)¹⁷ and IOSCO's Principles for the Valuation of Hedge Fund Portfolios (2007)¹⁸ for further guidance in this area.

¹⁷ <http://www.aima.org>

¹⁸ <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD253.pdf>

Segregation of functions in valuation – Disclosure Standards and Guidance [6]

- **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to prepare and adopt a document (a “Valuation Policy Document”) covering all material aspects of the valuation process and valuation procedures and controls in respect of the fund. The Valuation Policy Document (which it is acknowledged will contain information which is proprietary to the hedge fund manager) should be reviewed regularly by the hedge fund manager, in consultation with the fund governing body, and be made available to investors upon request on a confidential basis.**

HFSB envisages that in most circumstances the Valuation Policy Document will describe:

- the responsibilities of each of the parties involved in the valuation process;
 - the processes and procedures in place that are designed to ensure conflicts of interest are managed effectively;
 - the relevant material provisions of any service level agreements (SLAs) entered into with third parties responsible for or involved in the valuation process (excluding details of commercial aspects of any such SLAs); and
 - the controls and monitoring processes in place that are designed to ensure that the performance of any third party to whom the valuation function is outsourced is satisfactory.
- **Where a hedge fund manager is involved in the valuation process, it should disclose in its own marketing materials, and/or do what it reasonably can to enable and encourage the fund governing body to disclose in the fund's offering documents, any actual or likely material involvement of the portfolio management team in the valuation process. Investors should then be informed, for example via manager newsletters, of any material changes to such level of involvement.**

This could be satisfied by disclosing an estimate of the percentage of the fund's assets which have been, or are expected to be, valued with some input from the portfolio management team or a description of components of the portfolio for which the portfolio management team usually makes a contribution to the valuation process.

Hard-to-value assets – Governance [7]+[8]

In addition to the issues identified above in relation to the separation of responsibility for valuing a fund's assets from the portfolio management function, particular issues arise where a fund invests in hard-to-value assets.

While market prices for exchange-traded instruments are usually obtainable from exchanges or recognised data vendors, complex assets are often valued according to broker quotes or pricing models (see box over) since market prices are not readily available.¹⁹

In addition, some hedge funds invest in hard-to-value assets, including shares in companies which are privately owned or are being prepared for initial public offerings ("IPOs"). Such investments may be held with the intention of keeping them for a period of years until an "event" such as a third party sale, IPO or liquidation of the asset occurs. Since the asset is privately held, it is likely that no trading or market price will be available until the anticipated trigger event occurs. One approach that hedge fund managers may employ is to place such assets in "side pockets" (see box below).

As noted in the previous section, it is essential to investors that asset valuation accurately reflects "fair value"²⁰ for all assets. Given that hard-to-value assets may give rise to particular difficulties, it is important that the relevant valuation processes employed should ensure fair, consistent and dependable pricing. In addition, the difficulties which arise with subscriptions and redemptions in funds with significant amounts of hard-to-value assets should be properly managed (see box over).

The HFWG identified the following issues in relation to the valuation of hard-to-value assets:

- Do hedge fund managers adequately manage challenges arising in valuing hard-to-value assets where reliable market data is not available?
- Do hedge fund managers ensure that such assets are valued consistently?
- Do hedge fund managers provide sufficient information to investors to enable them to understand how such assets are valued?

Side-pockets

As noted above, where a hedge fund invests in hard-to-value assets with the intention of keeping them for a period of years until an "event" such as a third party sale, IPO or liquidation of the asset occurs, it is likely that there will be no trading and no market price available until the anticipated trigger event occurs. As a result, difficulties arise when investors subscribe for, or redeem investments in, hedge funds which are holding hard-to-value assets.

On the one hand, if the hard-to-value asset is accounted for at cost²¹, an investor redeeming its investment in a fund just before the "event" would not share in a potential rise in value caused by that event. On the other hand, investors subscribing to the fund just prior to such event would benefit in an unwarranted manner from the sudden valuation uplift. Even if valuation models or third party estimations were employed to value these hard-to-value assets while held, this would not guarantee fair treatment of investors since the realised value may still differ significantly from the estimates.

One common approach designed to overcome this is to place hard-to-value assets of this type into side pockets such that only investors in the fund at the time at which the relevant asset is acquired will participate in any investment gains or losses attributable to that asset. Side pockets thereby help to overcome valuation difficulties arising from longer-term hard-to-value investments and allow fair treatment of investors.

¹⁹ It is important to bear in mind that the valuation of exchange traded positions can also be uncertain, particularly if a position is large, because a recent price published by an exchange may be very different from the price at which the investment could be liquidated. Ideally, all of these liquidity-related concerns should be considered together.

²⁰ In other words, the current amount at which an asset could be exchanged between knowledgeable willing parties in an arm's length transaction. More detail on fair value can be found in AIMA's Guide to Sound Practices for Hedge Fund Valuation (2007), Appendix 4.

²¹ May be subject to regional accounting standards.

Pricing models

Hedge fund managers use pricing models to estimate the current fair value of many hard-to-value assets which are not continuously traded and for which no current market price is available. Banks and other financial institutions commonly use such models, particularly for valuing derivative positions. The models are usually developed by third party software vendors or internally by hedge fund managers or their trading counterparts.

Such models usually attempt to estimate asset prices based on factors which have been observed to drive valuations in the past. This calibration, based on historical data, can be a limitation on pricing models. Factors that have strongly affected prices in the past might not drive prices in the future. The reliability of the model therefore needs to be tested regularly against observed market prices.

When considering the quality of pricing models for valuation, it is important to distinguish between, on the one hand, vanilla derivatives (such as equity swaps) which can be valued by standard off-the-shelf software models and, on the other hand, complex, structured, one-off contracts for which valuation is more difficult.

It is important that hedge fund managers put in place processes for monitoring and managing pricing models, including handling of overrides to model inputs or results (see Standards and Guidance below).

FSA Principles

Relevant FSA Principles include:

- (1) Integrity – a firm must conduct its business with integrity.
- (2) Skill, care and diligence – a firm must conduct its business with due skill, care and diligence.
- (3) Management and control – a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
- (6) Customers' interests – a firm must pay due regard to the interests of its customers and treat them fairly.

Hard-to-value assets – Governance Standards and Guidance [7]

- **Where a hedge fund manager performs valuations of what it considers to be hard-to-value assets in-house or is otherwise involved in providing final prices to the valuation service provider, it should do what it reasonably can to enable and encourage the fund governing body to adopt valuation procedures for such assets which are aimed at ensuring a consistent approach to determining fair value and ensure that such procedures are set out in the Valuation Policy Document.**

HFSB envisages that such procedures would in most circumstances include:

- details of a hierarchy of pricing sources and models to be used for each asset type in a fund's portfolio (where relevant);
- if using broker quotes:
 - making reasonable efforts to identify and draw upon multiple (typically 2-3) price sources (where available);
 - specifying the acceptable tolerance ranges when multiple pricing sources are used and the approach to handling "outliers";
 - ensuring consistency and avoiding "cherry picking" of favourable price sources by using the same brokers at each valuation point; and
 - where the hedge fund manager arranges the provision of broker prices (as opposed to the administrator or other third party valuation service provider), the hedge fund manager should instruct brokers to send the prices directly to the administrator (or other third party valuation service provider);
- if using pricing models, the hedge fund manager doing what it reasonably can to enable the fund governing body to have a process specified in the Valuation Policy Document for:
 - approving pricing models including back-testing, documentation and approval by the fund governing body or its valuation committee;
 - monitoring and verification against observed market prices; and
 - governing manual overrides of the model inputs or results, including approval, documentation and reporting to the fund governing body or its valuation committee.
- **If using side pockets, a hedge fund manager should ensure that the fund governing body has been consulted on, and consented to, the circumstances in which side-pockets may be used and should do what it reasonably can to enable and encourage the fund governing body to:**
 - **describe the types of asset eligible for side pocketing in the Valuation Policy Document and disclose the same and the side pocketing process in the fund's offering documents;**
 - **ensure that side-pocketing occurs either on or about the time the relevant asset is purchased or on or about the point at which, in the manager's view, the relevant asset becomes hard-to-value and that the initial valuation of an asset on entering a side-pocket is at cost²², the last available market price (as appropriate) or a lower number or nil;**

22 May be subject to regional accounting standards.

- ensure that where a limit to the total amount of assets which may be included in side-pockets is disclosed in the fund's offering documents, such limit is not breached;
- ensure that management fees, if charged, for the side pocketed assets are calculated on no more than the lower of cost (or last available market price in the case of a previously liquid asset) or fair value; and
- ensure that any performance fees accrue for the duration of the existence of the side pocket and are paid only at the point at which the asset is finally disposed of or a liquid market price is available.

Hedge fund managers should refer to AIMA's Guide to Sound Practices for Hedge Fund Valuation (2007)²³ and IOSCO's Principles for the Valuation of Hedge Fund Portfolios (2007)²⁴ for further guidance on the valuation of hard-to-value assets.

Hard-to-value assets – Disclosure Standards and Guidance [8]

- **A hedge fund manager should periodically disclose the percentage of the fund's portfolio that is invested in what the manager considers to be hard-to-value assets (eg via newsletters) and, where meaningful and applicable, the extent to which internal pricing models or assumptions are used to value certain components of the fund's portfolio invested in hard-to-value assets.**

To enhance clarity and consistency of disclosure, hedge fund managers may wish to classify assets by the valuation methodology used (eg by adopting the fair value hierarchy used in FAS 157²⁵).

- **Notification of any material increase (as determined by the fund governing body) in the percentage of a fund's portfolio invested in what the manager considers to be hard-to-value assets should be disclosed to investors in a timely manner, eg via the manager's newsletters.**
- **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to ensure periodic reporting of the value of side pockets in the fund's audited annual accounts in accordance with applicable accounting standards.**
- **A hedge fund manager conducting valuations in-house should discuss with the fund governing body any material issues in relation to the valuation of what the manager considers to be hard-to-value assets (eg unavailability of a sufficient number of pricing sources or dispersion of broker quotes beyond tolerance levels) and, if the fund governing body considers it appropriate, do what it reasonably can to enable and encourage the fund governing body to disclose the same to investors.**

²³ <http://www.aima.org>

²⁴ <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD253.pdf>

²⁵ <http://www.fasb.org/pdf/fas157.pdf>, p. 22.

Risk Management [9]-[20]

Understanding, managing, taking and controlling risk is the essence of the hedge fund business and lies at the core of FSA Principles 1 (integrity), 3 (management and control) and 4 (financial prudence). The risks taken by hedge fund managers affect a wide variety of stakeholders, including investors, prime brokers/lenders and the managers themselves, and are also important for financial stability. Therefore, assuring investors, supervisors and hedge fund counterparties that managers have a responsible approach to risk is essential to maintaining confidence in the sector.

It is important to note, however, that failure and poor performance will occur, and no risk management approach or system can or should be expected to prevent failure and poor performance.

The following sections of this report set out HFSB's proposed risk management best practices, which are about managers establishing the following:

- A risk framework, helping managers to think about risk in a structured manner (Standards [9]-[10])
- Standards covering management of:
 - Portfolio risk (Standards [11]-[16])
 - Operational risk (Standards [17]-[18])
 - Outsourcing risk (Standards [19]-[20]).

Risk Framework [9] + [10]

Given the complexity and breadth of risk issues, managers should think about risk in the context of a risk framework. The framework should cover governance aspects and all significant categories of risk, thereby providing a structure for consistently evaluating and managing risk.

The HFWG identified the following issue on managing risk:

- Do hedge fund managers have a consistent risk management framework and can they adequately explain their approach to risk management?

FSA Principles

- (1) Integrity – a firm must conduct business with integrity.
- (3) Management and control – a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
- (4) Financial prudence – a firm must maintain adequate financial resources.
- (6) Customers' interests – a firm must pay due regard to the interests of its customers and treat them fairly.

Risk framework - Governance Standards and Guidance²⁶ [9]

- **A hedge fund manager should put in place a risk framework which sets out the governance structure for its risk management activities and specifies the respective reporting lines, responsibilities and control mechanisms intended to ensure that risks remain within the the manager's risk tolerance as conveyed to and discussed with the fund governing body.**

Risk tolerance is sometimes also referred to as risk appetite and describes the willingness of an organisation to assume risks. Management of the relevant organisation has to decide how much risk it is willing to take in each area of risk and then take action to manage or mitigate these risks accordingly. Therefore, for the risk manager, appetite refers to portfolio, operational and outsourcing risk.

- **The framework should cover all relevant categories of risk including portfolio, operational and outsourcing risks.**

Risk framework - Disclosure Standards and Guidance [10]

- **A hedge fund manager should explain its approach to managing risk (its risk framework) to the fund governing body and do what it reasonably can to enable and encourage the fund governing body to explain, to the appropriate extent, such risk framework in the fund's offering documents.**

The following table provides an overview of the different risk categories which should be covered by the risk framework and where best practice is detailed in the subsequent sections.

²⁶ Risk frameworks and the concept of risk appetite are common in the banking industry, as described in The new Finance and Risk agenda, What is your risk appetite? (Oliver Wyman), http://www.oliverwyman.com/ow/pdf_files/the_new_FnR_agenda_FNR_0307.pdf.

Risk category overview

Category	Description	Risk for whom	Covered in Standards
Portfolio risks	Risk of losses in the investment portfolio	Direct risk for investors, indirect (reputational) risk for the manager	[11]-[16]
Operational risks	Risk of breakdowns in internal controls or systems which can lead to financial losses	Direct risk for the manager, indirect risk for investors	[17]-[18]
Outsourcing risks	Risk of failures in the delivery of services by third parties	Direct risk for the manager, indirect risk for investors	[19]-[20]

Portfolio Risk [11]-[16]

The HFWG identified the following issues on portfolio risk:

- Do hedge fund managers adequately monitor portfolio risks to ensure alignment with stated risk appetite?
- Is the risk appetite of hedge funds adequately disclosed in managers' marketing materials and/or funds' offering documents so that investors can fully understand and distinguish the risk profiles of different funds?
- Do hedge fund managers provide ongoing disclosure to investors as to the fund's risk taking?

The section below provides best practice standards and guidance relating to the following areas of portfolio risk management:

- **Governance (Standard [11]):** adequate governance of the risk function to ensure that potential conflicts of interest between the hedge fund manager and the investor are properly mitigated.
- **Measurement (Standards [12], [13], [14]):** adequate measurement of the different sources of portfolio risk.
- **Control (Standard [15]):** monitoring processes to ensure the portfolio remains within the boundaries set.
- **Investor disclosure (Standard [16]):** assuring investors that risk management processes are in place.

Others have also developed high quality materials on portfolio risk management, including AIMA²⁷, MFA²⁸ and the Risk Standards Working Group²⁹. The HFWG recommends these documents as further guidance for hedge fund managers in developing and enhancing their approach to portfolio risk management.

FSA Principles

- (1) Integrity – a firm must conduct its business with integrity.
- (2) Skill, care and diligence – a firm must conduct its business with due skill, care and diligence.
- (3) Management and control – a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
- (4) Financial prudence – a firm must maintain adequate financial resources.
- (10) Clients' assets – a firm must arrange adequate protection for clients' assets when it is responsible for them.

For disclosure:

- (7) Communications with clients – a firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.
- (9) Customers: relationship of trust – a firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.

27 AIMA: Sound Practices for European Hedge Fund Managers (2007), <http://www.aima.org/uploads/GuidetoSoundPracticesforEuropeanHFMMay2007.pdf>

28 Managed Fund Association: MFA's Sound Practices for Hedge Fund Managers (2007) <http://www.managedfunds.org>

29 Risk Standards Working Group: Risk Standards for Institutional Investment Managers and Institutional Investors, <http://www.cmra.com/risk.pdf>

Portfolio risk - Governance Standards and Guidance³⁰ [11]

- **A hedge fund manager should ensure that adequate risk management processes and resources are available and well understood by portfolio managers, traders, risk managers, senior staff and other staff related to the management of the portfolio. A hedge fund manager should also discuss these risk management processes with the fund governing body and do what it reasonably can to assist the members of the fund governing body to understand such processes.**
- **Potential conflicts of interests in the risk monitoring process should be managed by clearly separating the risk monitoring function from portfolio management. If a smaller or start-up manager considers it impractical to do so, it should disclose this in its marketing documents and do what it reasonably can to enable and encourage the fund governing body to disclose this in the fund's offering documents.**

HFSB recognises that notwithstanding the separation of the risk monitoring and portfolio management functions, portfolio managers will typically provide input into the risk parameters to be applied to the portfolio (eg types of trades, degree of risk and areas of risk).

- **Risk monitoring reports should be made to the person or body which has ultimate responsibility for risk management (such as the manager's chief investment officer, chief executive officer or management committee).**
- **A hedge fund manager should put in place a written Risk Policy Document, a copy of which should be supplied to the fund governing body. This document should set out the responsibilities of and procedures to be employed by the hedge fund manager's risk monitoring function.**

HFSB expects that in most circumstances the Risk Policy Document might, amongst other things, include:

- guidelines for distribution of risk mandates among individual sub-portfolio managers and the setting and changing of risk limits;
- routines for risk reporting, exceptions reporting and escalation procedures;
- routines for reviewing and testing the risk measurement framework;
- guidelines for risk monitoring and risk measurement during stressed periods; and
- routines for communicating the above information to all relevant persons within the hedge fund manager in a clear and understandable manner.

Portfolio risk - Measurement [12-14]

Risk measurement is a complex area involving the use of sometimes standardised risk indicators which provide comfort if they are within the boundaries of the stated risk limits. Although a measure such as Value-at-Risk (“**VaR**”) can be of real value in controlling certain risks, it can also provide false comfort if it is used inappropriately.

Risk measurement therefore requires a sound understanding of the dynamics and the nature of risks in the portfolio (both in normal as well as stressed market conditions) before selecting appropriate and coherent risk measures to control them. Given the breadth of hedge fund strategies and emerging new risk profiles within the sector, there is no single risk measure appropriate in all circumstances and it would be unwise to rely on just one measure without supplementing it with other risk analyses and with allowing human intervention the last word.

³⁰ Further guidance can be found in AIMA's Guide to Sound Practice for European Hedge Fund Managers (2007), 2.1.2.

The following sections provide an overview of best practice standards for measuring **liquidity, market** and **counterparty** risk.

Liquidity risk management

A hedge fund needs cash to invest, meet investor redemptions and margin calls, and pay creditors and expenses. The sources of liquidity are available cash, fund subscriptions, liquid assets that can be sold quickly and credit lines with prime brokers and other lenders. Liquidity risk refers to the risk of a fund not being able at all times to meet its obligations to creditors, counterparties or investors.

The leveraged³¹ nature of many hedge funds may make their cash position more sensitive to sudden market distress than that of long-only funds. The complexity arises when, for example, unexpected falls in market prices trigger sudden margin calls, which have to be met by asset liquidations by the fund (which in turn might cause asset prices to drop). Hedge fund managers should therefore be vigilant in measuring and managing liquidity risks.

Liquidity risk management - Standards and Guidance [12]

- **A hedge fund manager should develop a liquidity management framework, the primary role of which is to limit the risk that the liquidity profile of the fund's investments does not align with the fund's obligations.**

This could include forecasting the liquidity position of the fund and tracking liquidity measures (eg ratios such as "available cash/VaR") which allow the hedge fund manager to assess the probable development of the fund's liquidity position relative to the portfolio's inherent risk.

The nature of this framework would depend on the categories of assets and leverage profile of the hedge fund.

- **A hedge fund manager should regularly conduct stress testing and scenario analysis of the fund's liquidity position.**

Potential stress events could include:

- margin calls due to sudden severe market shocks (eg significant equity price falls);
- reduction in liquidity in certain market segments relevant to the fund;
- a sudden increase in collateral requirements for funding positions (thereby reducing assets available for sale to meet liquidity needs);
- investor redemptions (as per the fund's redemption policies) (where relevant³²); and
- cancellation of credit lines (as per notice periods agreed between the fund and counterparties such as prime brokers).

The stress testing/scenario analysis should also take account of the impact of market risk stresses on the liquidity position of the fund (see following market risk management standard).

It has been widely found that in stress situations unexpected correlations can appear. Hedge funds have been faced with sudden liquidation challenges due in part or in whole to rapid market movements, for example in currencies, commodities or equities.

31 Further guidance can be found in AIMA's Guide to Sound Practice for European Hedge Fund Managers (2007), 2.1.2.

32 Will only be relevant for open-ended hedge funds.

Market risk management [13]

Market risk refers to the risk of losses to the portfolio due to fluctuations in, for example, interest rates, equities and commodity prices and foreign exchange rates. It also includes factors such as volatility risk³³ and correlation risk³⁴.

- **A hedge fund manager should develop measures to identify market risk in the fund's portfolio. To overcome the shortcomings of individual measures, the hedge fund manager should rely on multiple techniques.**

These could include, amongst others:

- volatility measures;
- VaR type approaches;
- Monte Carlo simulation³⁵;
- stress tests/scenario analyses³⁶;
- impact of leverage; and
- portfolio concentration measures.

- **A hedge fund manager should conduct regular stress testing/scenario analysis to assess the impact of extreme market occurrences on the value of the portfolio.**

Extreme financial events may not receive sufficient attention when using classic risk measures such as volatility and VaR due to the scarcity of historical observations for extreme financial events. Stress testing/scenario analysis allows managers to overcome this shortcoming by accounting for the increased inter-correlation between different asset classes at times of market turmoil³⁷.

Stresses could include, among other things, equity price drops, sudden shifts of interest rate curves and abrupt changes in foreign exchange rates. A scenario analysis would combine several of these “stresses” across markets at the same time based on extreme assumptions about correlations which may not occur in normal markets.

The analysis could include, among other things, scenarios based on historically observed crises (eg the bursting of the new economy bubble in 2000 or the sub-prime mortgage crisis in 2007) and newly developed (“made-up”) scenarios to incorporate emerging correlations and new risks, and their respective impacts on the portfolio.

Hedge fund managers should also assess basis risk arising from imperfect hedging strategies³⁸ and incorporate resultant uncertainties into their stress testing/scenario analysis approach.

- **A hedge fund manager should account for valuation sensitivities under stressed conditions in its approach to risk measurement (eg VaR, stress testing/scenario analysis).**

In times of abrupt market fluctuations, situations can arise where market liquidity is much lower than is usually observed, making it difficult to trade positions at observed market prices. Under such circumstances, a fund's net asset value may not only be hard to calculate, but also unattainable in the event sales are attempted. At the same time, the manager might be forced to sell positions, for example in order to meet redemption requests and/or margin calls.

33 Volatility risk: the risk of a change in the (expected) volatility of a price of an asset (which could for example affect option prices).

34 Correlation risk: the risk of change in the (expected) correlation between asset prices.

35 Monte Carlo simulation: statistical evaluation of risks, where a large number of “scenarios” is generated based on random samples for uncertain underlying variables.

36 A stress test simulates a significant market move (eg 30% equity price drop) and measures the impact on the fund's value. In a scenario analysis, multiple stresses are applied simultaneously (eg 30% equity price drop, shift in interest rates, etc).

37 Also sometimes referred to as “fat tails”, which means that extreme occurrences are more likely to occur than theoretically expected.

38 For example, when the price of a future varies from the price of the underlying instrument as expiry approaches. The imperfection of hedging strategies is likely to be higher the more immature the market.

Market risk management - Standards and Guidance [13]

The risk measurement framework should account for this, for example by applying valuation discounts for modeling purposes to positions that might have to be liquidated under stressed conditions (see Standard [12] (*Liquidity risk management*)).

- **A hedge fund manager should translate the results of the analysis of market risks (stress tests/scenario analysis, etc) into timely management action (eg adjustment of positions) as part of the control and risk management process.**

Limitations of individual risk measures

In early 2007 problems emerged in the sub-prime mortgage market causing sharp falls in the prices of collateralised debt obligations (“**CDOs**”) and other related derivatives underpinned by mortgage repayments. The lowest rated derivatives, linked to the first losses incurred from mortgage defaults, fell in price first. But subsequently, even the highest rated derivatives such as AAA-rated CDOs also experienced sharp price drops – up to 10% in a few days.³⁹

Such price volatility is not usually associated with AAA-rated derivatives, and may have reflected liquidity issues and hedging-driven trading as opposed to a repricing based on a revision of fundamental value. Investors who had bought such instruments on the basis of their rating were probably surprised. But without such ratings, an investor using normal risk measures would have found it difficult to assess the risk such instruments posed.

Historical VaR measures would have offered little guidance because for some types of the derivatives there was little historical experience to draw on, and where histories did exist they had been generated in a benign macroeconomic environment. Scenario analysis and stress testing – seeing how the instruments might be expected to behave in a less benign economic environment – might have revealed more information. This shows that scenario and stress frameworks should also strive to capture market dynamics such as forced selling (for example, because of losses incurred on over-rated derivatives) and volatility of liquidity premiums.

Counterparty credit risk management [14]

Hedge fund managers enter transactions with various trading counterparties including, among others, prime brokers, lending banks and exchanges. Counterparty credit risk refers to the risk of loss due to a trading counterparty defaulting on its obligations. This risk is particularly relevant to derivative positions, where the exposure between counterparties fluctuates over the life of the contract. Hedge fund managers following best practice will implement a spectrum of measures to monitor and contain counterparty credit risks to acceptable levels.⁴⁰

39 Eg during the month of July 2007 the ABX AAA 07-01 index dropped in price from 99.5 to 88.

40 Further detail has been provided by the CRMPG (2005), *Towards Greater Financial Stability: A Private Sector Perspective* (2005), section III (Improving Transparency and Counterparty Credit Assessments), <http://www.crmppolicygroup.org> See also MFA's *Sound Practices for Hedge Fund Managers* (2005) (4.9).

Counterparty credit risk management - Standards and Guidance [14]

- **A hedge fund manager should have a process for setting up trading relationships on behalf of the fund, including the assessment of creditworthiness and the setting of risk limits.**

In setting up such trading relationships, a hedge fund manager may, where relevant and appropriate, wish to consider putting netting agreements and appropriate collateral arrangements in place. For example, it may be possible for certain funds to agree two-way collateral posting with a trading counterparty.

- **Creditworthiness of the fund's trading counterparties should be monitored periodically and risk limits adjusted if required**

Control processes

There is little point in having sophisticated risk measurement methodologies unless the results are translated into management action.

Control processes - Standards and Guidance [15]

- **A hedge fund manager should track a fund's adherence to its stated investment objectives, investment policy/strategy and investment and other restrictions and take appropriate corrective action if a breach of investment policy/strategy or of any restrictions or limits occurs.**

To assist in tracking a fund's adherence to its stated investment objectives, investment policy/strategy and investment and other restrictions, hedge fund managers should carefully consider setting internal limits and sub-limits at the outset for the aggregate portfolio and, where applicable, to all individual sub-portfolios (each of which would be subject to override by the hedge fund manager's chief executive officer, chief investment officer, management committee or similar). These limits could include general investment restrictions (eg eligible asset classes, geographic location of risk) and could also encompass various categories of risk such as market risk, funding liquidity risk, counterparty credit risk and other relevant risk factors such as concentrations (eg in relation to single names, sectors or hard-to-value assets).

Risk reporting should be put in place so that the investment decision-makers have a daily (or more frequent if appropriate) view of the risk position of the fund and are in a position to prevent breaches of any relevant limits and restrictions. Breaches of any relevant limits or restrictions should be immediately reported to the relevant fund manager, the manager of the trading activity and the compliance officer, with escalation as needed to the manager's chief executive officer, chief investment officer, management committee or similar. A process for determining when and how breaches should be reported to the fund governing body should be put in place (a manager will want to ensure that such process takes into account insurance related considerations).

The process should be designed to ensure that, if required, the findings of the stress testing/scenario analyses are translated into mitigating portfolio risks.

Portfolio risk - Disclosure Standards and Guidance [16]

- **A hedge fund manager should disclose and explain its investment and risk management approach in its own marketing materials and do what it reasonably can to enable and encourage the fund governing body also to include, to the appropriate extent, such disclosure and explanation in the fund's offering documents. In addition to disclosure recommended in Standard [1] (*Investment policy and risk disclosure*), a summary of the risk framework (processes and risk management techniques employed) should be disclosed.**

Hedge fund managers should also carefully consider whether it would be appropriate to disclose target ranges or averages as anticipated by the manager for specific risk parameters and how short-term deviations from such target ranges are handled, and advise the fund governing body accordingly. This could include:

- volatility of returns;
- VaR or equivalent (eg potential loss arising from a stress event);
- leverage (according to the manner in which the manager measures leverage)⁴¹; and
- limits to the percentage of the portfolio which can be invested in non-marketable securities⁴² (or another measure of liquidity).

- **A hedge fund manager should ensure that the management report submitted with the audited annual accounts of the hedge fund includes disclosures on the actual risk profile of the fund for the relevant period.**

HFSB envisages that this might include:

- the actual risk profile of the fund, where applicable using risk measures such as
 - realised volatility of returns;
 - VaR type measures (actual, average, range for observation period and decomposed by, for example, risk type and market); and
 - leverage (high, low, average for the respective observation period), if applicable;
- the percentage of the portfolio invested in what the manager considers to be hard-to-value assets (see more detailed disclosure requirements for hard-to-value assets in the Standards relating to valuation); and
- investment instruments used during the relevant period.

Hedge fund managers should carefully consider whether providing more frequent (eg quarterly) disclosure of relevant performance and risk measures to investors through a suitable medium (eg newsletters) would be appropriate.⁴³

HFSB acknowledges that investors may require more frequent disclosures via newsletters than the annual disclosures set out above. However, the frequency, required content and granularity of such disclosures will be a function of the fund's strategy. For example, high turnover strategies may require more frequent disclosure than private or distressed debt strategies. Risk measures used may also differ substantially between funds. Therefore, HFSB has not sought to be prescriptive in this area.

41 See Appendix E (*Leverage*) for examples of leverage measures.

42 Marketable Securities: Securities, that can be easily liquidated into cash, for example government securities, stock, bonds, notes, commercial paper and other financial instruments that are regularly listed for sale on recognised public exchanges.

43 Further guidance on risk measures is provided by the Investor Risk Committee Report – Hedge Fund Disclosure for Institutional Investors, Section 1, issued by the International Association of Financial Engineers, <http://www.iafe.org/upload/IRCConsensusDocumentJuly272001.pdf>

Operational Risk [17]+[18]

Managing and mitigating operational risk is important for a sound approach to risk management by hedge fund managers. Operational risk includes breakdowns in internal controls, systems and corporate governance and unexpected disasters which can lead to financial losses from failure to perform, error and fraud.

Guidance on operational sound practices for hedge fund managers can fill many manuals and goes beyond the scope of this Report, but there are several areas where HFSB considers compliance with best practices to be particularly important⁴⁴:

- People and governance
- Trading and execution
- Fraud and financial crime prevention
- Disaster recovery
- IT systems
- Model risks
- Legal and regulatory risk.

FSA Principles

- (1) Integrity – a firm must conduct its business with integrity.
- (2) Skill, care and diligence – a firm must conduct its business with due skill, care and diligence.
- (7) Communications with clients – a firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.
- (8) Conflicts of interest – a firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
- (10) Clients' assets – a firm must arrange adequate protection for clients' assets when it is responsible for them.

⁴⁴ The Basel Committee on Banking Supervision has produced valuable material on sound practices for managing operational risk in the banking industry (eg <http://www.bis.org/publ/bcbs96.pdf>). Further materials have been produced by industry bodies such as AIMA and MFA and are highlighted below.

People and Governance

Operational risk - Governance Standards and Guidance [17a]

- In areas where potential conflicts of interest could arise (valuation, risk management, compliance), a hedge fund manager should clearly divide these activities from the portfolio management function with separate reporting lines into the manager's chief executive officer or chief investment officer or similar. If a smaller or start-up manager considers it impractical to do so, it should disclose this in its marketing documents and do what it reasonably can to enable the fund governing body to disclose this in the fund's offering documents.
- A hedge fund manager's staff remuneration should not set false incentives (eg by linking the compensation of the valuation team directly to fund performance).
- A hedge fund manager should ensure that material aspects of its operational procedures are adequately documented and training is provided to staff. This should include, among other things, areas such as compliance procedures, back-up/disaster recovery procedures, personal account dealing policies and client confidentiality. A hedge fund manager should also periodically test its compliance procedures or have them audited by an external party.

Trading and execution

Hedge funds are exposed to trading-related risks, including failed trades, price overrides and trade confirmation backlogs, which could ultimately expose the fund to market, credit and liquidity risks. These operational issues are not particular to hedge fund managers, but also affect banks and long-only asset managers.⁴⁵

Operational risk – trading and execution Standards and Guidance [17b]

- **To prevent trading and execution failures, a hedge fund manager should put effective trading and counterparty procedures in place.**

This might include the following aspects:

- entering into master agreements with trading counterparties;
- agreeing well defined termination and collateral policies;
- tracking changes in key provisions of any agreements with trading counterparties; and
- a robust trade confirmation and reconciliation process including, amongst other things:
 - sufficient back- and middle-office capacity to handle trading volumes;
 - daily confirmation of trades and positions;
 - use of electronic matching and confirmation systems (depending on the scale of the manager - smaller managers and managers with low trading volumes may rely to a larger extent on manual handling);
 - timely reconciliation of complex over-the-counter trades and loans; and
 - monitoring of corporate action events (eg voting, splits, spin-offs) on long and short equity derivative instruments and applying the events to fund accounts.

⁴⁵ Further guidance on sound practices for transactional practices can be found in AIMA's Guide to Sound Practices for European Hedge Fund Managers (2007), sections 3.3 and 3.4; and MFA's 2005 Sound Practices for Hedge Fund Managers (section VI).

Documentation issues

There are numerous illustrations where the interplay of legal and documentation risks surface between hedge funds and the dealer, investor and regulatory community. Indeed, the origins of much of the credit and counterparty and investor risks in the market lie in the more remote and less understood world of the legal agreements that surround them. Several years ago the industry broadly agreed that assignment of contracts in the credit derivative markets had become unnecessarily risky and needed redress. For years, the industry had been beset by a high percentage of assignments which had been poorly documented between dealers and end user counterparts involving credit derivative transactions. The NY Federal Reserve, assisted by the FSA, intervened and, with the major dealers, identified the key triggers and drivers. The CRMPG then set out a series of recommendations that quickly found their way into a protocol of agreements between large dealers and hedge funds globally, vastly reducing the number of undocumented and unsigned assignments within a short time. This set of private sector initiatives reversed years of increased operational and legal risks and restored much needed stability to the market.

There is a series of issues relating to legal risk where documentation is very important. Hedge funds and their dealer and investor colleagues interact with one another on a series of topics including:

- enforceability of master netting agreements across legal jurisdictions;
- trigger mechanisms as to what determines a default action in a master agreement based upon insufficient NAV; and
- language on margin lock ups and terms and conditions of those time frames.

It is important that funds and dealers continually strive to achieve best practice in the field of documentation and legal compliance since the ability to ensure broad enforceability of their documents is critical to their success and how their professionalism is viewed in the marketplace.

Fraud and financial crime prevention

Financial crime and fraud pose a serious threat to individual managers and can undermine the integrity of the financial services sector and markets as a whole⁴⁶.

⁴⁶ Further references: FSA handbook (eg SYSC 3.2) <http://fsahandbook.info/FSA/html/handbook/SYSC/3/2/>, FSA website: http://www.fsa.gov.uk/Pages/About/What/financial_crime/money_laundering/index.shtml. Detailed information on prevention of money laundering is also provided by the Joint Money Laundering Steering Group (JMLSG), www.jmlsg.org.uk.

Operational risk – fraud and financial crime prevention Standards and Guidance [17c]

- **A hedge fund manager should be confident that it understands the applicable laws and regulations in the markets in which it deals and has effective systems and controls in place to enable it to identify, assess, monitor and manage the risk that it is used to further financial crimes.**

This may apply to areas such as:

- anti-money laundering procedures⁴⁷ (although typically the fund's administrator will be responsible for compliance);
 - procedures to prevent market abuse offences (see also Standard [23] (*Prevention of market abuse*)); and
 - strict internal controls to prevent misappropriation of client money (eg co-signing policies), where client money is held by the manager.
- **A hedge fund manager should appoint a compliance officer who is independent of the portfolio management function to oversee all issues relating to regulatory compliance and market and professional conduct. If a smaller or start-up manager considers it impractical to do so, it should disclose this in its marketing documents and do what it reasonably can to enable the fund governing body to disclose this in the fund's offering documents. The compliance officer should report regularly to the manager's chief executive officer or management committee or equivalent. A hedge fund manager should provide to the fund governing body a report on regulatory compliance prepared by the compliance officer on a regular basis.**

Disaster recovery

Various internal and external events such as building fire, terrorism or avian flu could interrupt operations in the absence of disaster recovery and business continuity plans being created and tested.⁴⁸

Operational risk – disaster recovery Standards and Guidance [17d]

- **A hedge fund manager should put in place measures designed to ensure that the provision of fund management services to the fund will remain possible in the event of a disaster. The level of tolerance should be agreed by the executive committee of the hedge fund manager and, where relevant, be notified to the fund governing body.**

Depending on the scale of the hedge fund manager's business, this could include:

- a communication plan to contact important parties (such as senior management, prime broker, administrator and regulator);
- contingency plans (including a succession plan to address key man risk, fall back communications router and capabilities);
- offsite data back-up facilities;
- back-up office space/infrastructure (applicable to larger hedge fund managers); and
- regular testing of procedures/processes.

47 Further guidance on Anti-Money Laundering Regulations can be found in AIMA's Guide to Sound Practices for European Hedge Fund Managers (2007), (section 4.1.5).

48 Further guidance on sound practices for disaster recovery procedures can be found in AIMA's Guide to Sound Practices for Business Continuity Management for Hedge Fund Managers (2006), AIMA's Sound Practices for European Hedge Fund Managers (2007), (eg 3.9); and MFA's Sound Practices for Hedge Fund Manager (2005) (VII).

Model risk

The investment process, risk management and hedging strategies hedge fund managers pursue often depend on models which can leave them exposed to certain types of model risk. Model risk refers to the risk that arises when the models used are:

- applied to tasks for which they are inappropriate;
- based on incorrect assumptions; and
- otherwise implemented incorrectly.

As a result, these models can, if used inappropriately, provide “false comfort” to hedge fund managers. This underlines the need for all models to be properly governed so that, where necessary, management use human judgment and override models.

The magnitude of model risk will be a function of the complexity of the hedge fund manager’s investment mandates, the nature of the assets and the range of models used. For example, a hedge fund manager focusing on exotic derivative markets where almost all trading decisions involve elements of complex evaluation models has greater exposure to this risk than an equity long/short manager that limits its use of models to company earnings simulations.

Operational risk – model risk Standards and Guidance [17e]

- **As part of its operational risk management procedures, a hedge fund manager should assess any exposure to model risk annually or as dictated by events and where model risk is perceived to be material to the performance of the manager, should implement appropriate procedures to ensure that material model risks are identified and mitigated where possible.**

Such procedures might include:

- evaluation of model risk in the model selection process;
- frequent review of models, including parameterisation, calibration, assumptions and data integrity;
- stress testing of assumptions;
- sign-off and documentation of management overrides (overrides can become necessary when models produce unreasonable results so that human intervention becomes necessary but such overrides need to be governed carefully);
- documentation of models to avoid key man risk; and
- security of algorithm and source code (back-up).

IT security

Like all other technologically dependent operations, hedge funds require support from systems and operations globally 24 hours a day throughout the year. As a result, measures such as secure offsite facilitation, disaster recovery and technological and systems recovery are essential⁴⁹.

⁴⁹ Further guidance on sound practices on IT security can be found in AIMA’s Guide to Sound Practices for European Hedge Fund Managers (2007), (section 3.9) and AIMA’s Guide to Sound Practices for Business Continuity Management for Hedge Fund Managers (2006).

Operational risk – IT security Standards and Guidance [17f]

- **A hedge fund manager should ensure security and integrity of systems and data.**

Depending on the scale of the manager, this could include system testing, offsite IT and data back-up, disaster recovery procedures and supervision of contract IT resources.

Legal and regulatory risk

Hedge fund managers often trade in securities in multiple jurisdictions and therefore need to understand applicable local rules and regulation.

Operational risk – legal and regulatory risk Standards and Guidance [17g]

- **A hedge fund manager should ensure that it understands local conduct of business rules and regulations which apply in the jurisdictions in which it operates (including any rules governing the passporting of regulatory authorisations from one jurisdiction to another). A hedge fund manager should also ensure that it understands laws and regulations relevant to the securities in which it trades (eg shareholding disclosure requirements and foreign ownership rules).**

Operational risk - Disclosure Standards and Guidance [18]

- **To enable investors and creditors to be confident that operational risks are managed satisfactorily, a hedge fund manager should make available a summary of its procedures and controls applying to the management of operational risk to investors and creditors undertaking due diligence.**

Outsourcing risk [19]+[20]

The hedge fund industry is traditionally based on a strongly unbundled business model, with managers focusing on what they are best at – managing the portfolio – while third parties provide other services such as:

- an administrator to handle, amongst other things, fund accounting and transfer agency services (for example, handling subscriptions for and redemptions of investments in the funds);
- a valuation expert (often also the administrator) to value the assets and investments in the fund's portfolio;
- one or more prime brokers to provide, amongst others, brokerage, stock-lending, financing, back and middle-office support (including clearing and settlement of trades) and other administrative services;
- one or more custodians (often also prime brokers) to provide custody services for the fund's assets; and
- an auditor to provide audit services for the fund's annual accounts.

All of these services are vital to the success of hedge funds. Ensuring that the selection and monitoring of third party service providers is properly managed is therefore of great importance to investors.

The HFWG identified the following issues in relation to third party services provided to the hedge fund:

- Do hedge fund managers take sufficient care and conduct adequate due diligence when recommending third party service providers for the fund?
- Are third party service providers adequately monitored?

- Do hedge fund managers themselves provide or, where appropriate, encourage the provision by other service providers of sufficient information to fund governing bodies to enable them to evaluate and review the appointment or continued appointment of third party service providers?
- Do hedge funds rely excessively on particular third party service providers who may lack robust infrastructure and fail to provide expected service levels?
- Is sufficient information provided to investors as to how third party service providers are selected and their performance monitored?

FSA Principles

Relevant FSA Principles include:

- (2) Skill, care and diligence – a firm must conduct its business with due skill, care and diligence.
- (3) Management and control – a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
- (10) Clients’ assets – a firm must arrange adequate protection for clients’ assets when it is responsible for them.

Outsourcing risk - Governance Standards and Guidance [19]

Third party services are normally provided under a contract between the hedge fund and the entity providing the service.

- **A hedge fund manager should ensure that careful due diligence on third party service providers is conducted before recommending them to the fund governing body.**

This could include using Due Diligence Questionnaires or evaluating “reports on controls” from an independent reporting accountant issued by the respective third party service provider⁵⁰.

- **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to review third party service providers properly and regularly.**

Valuation and administration

- **A hedge fund manager should, where appropriate, do what it reasonably can to enable and encourage the fund to put a service level agreement (“SLA”) in place with relevant service providers (commonly, this will be attached as a schedule to the agreement between the fund and the relevant service provider).**

A SLA would normally be expected to:

- set out in precise detail the services to be provided by the relevant service provider along with deadlines for completion of the services;
- make clear accountability and responsibility for the orderly operation of all administration or other functions performed by the relevant service provider on behalf of investors; and
- include “Key Performance Indicators” to provide hedge fund managers and fund governing bodies with a means of measuring whether the objectives set out in the SLA are met by the relevant service provider.

⁵⁰ Reports on controls under the (US) SAS70, (UK) AAF 01/06 or other standards include a report from an independent reporting accountant.

Further examples of the contents of SLAs are provided in Appendix J (Examples of functions often covered by service level agreements).

- **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to review the services provided by the relevant service provider against contractual or other agreed standards.**

Prime brokers

- **A hedge fund manager of a large hedge fund should carefully consider whether it is appropriate for the hedge fund to appoint more than one prime broker (taking into account in particular the potential advantages of diversification of funding and other services) and do what it reasonably can to enable and encourage the fund governing body to act accordingly.**

HFSB is aware that there is a spectrum of criteria to consider when choosing a prime broker, including efficiency and operational risk considerations.

In carrying out due diligence on a prime broker, a hedge fund manager should consider the potential prime broker's credit rating, policy on rehypothecation and general ability to fulfil all process functions accurately and efficiently.

Auditors

- **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to appoint reputable auditors.**

In addition to the Standards set out in this report, AIMA provides further guidance in its Guide to Sound Practices for European Hedge Fund Managers, (2007) (chapter 3.8).

Outsourcing risk - Disclosure Standards and Guidance [20]

- **A hedge fund manager should disclose the names of its principal third party service providers in its due diligence documents or upon request.**
- **A hedge fund manager should, to the extent it is able or permitted to do so, provide information on the fund's committed funding or financing arrangements with prime brokers/lenders to investors in its due diligence documents or upon request.**
- **A hedge fund manager should disclose the nature of any special commercial terms with its third party service providers which result in potential conflicts of interest (eg in-house brokerage or rebates).**
- **A hedge fund manager to the extent applicable should disclose the monitoring procedures in relation to its third party service providers in its due diligence documents or upon request.**

In addition to the Standards set out in this report, AIMA provides further guidance in its Guide to Sound Practices for European Hedge Fund Managers, (2007) (chapter 3.8).

Fund Governance [21]+[22]

Potential conflicts of interest can arise between hedge fund managers, the hedge funds which they manage and investors in those hedge funds, for example in relation to manager remuneration and other related factors. To mitigate these potential conflicts, appropriate governance mechanisms and oversight are required.

An important issue to consider on establishing a fund, therefore, is the mechanism for addressing and containing such potential conflicts of interest. This issue may not have been accorded great importance when the hedge fund industry was in its infancy, perhaps reflecting the fact that the relationships between managers and their relatively few private investors were more informal and managers themselves may have been the main investors. As such, these relationships were essentially based on mutual knowledge and trust at that time. As the industry has grown, however, the investor base has broadened with more and more institutional investors (insurance companies, pension funds, endowments and so on) and funds of funds starting to invest in hedge funds. For three reasons, HFSB considers that this change in the investor base requires a reinforcement of oversight processes:

- increasing remoteness between ultimate investors and hedge fund managers;
- increasing institutionalisation, with investors looking for a higher degree of comfort; and
- increasing “retailisation” of the ultimate investor base (for example, entry of retail investors and investment by insurance companies and pensions plans owing ultimate duties to retail investors).

Of course, not all hedge funds are the same and so best practice in any particular case may need to reflect the investor base, the size and age of a fund, how long the manager has held the position and other relevant factors. This indicates a “spectrum” of governance approaches:

- At one end of the spectrum are the more informal types of hedge funds, where the hedge fund managers themselves and their friends, families and other contacts are significant investors and there is a limited number of other sophisticated investors who are known to the manager. A more informal set of governance arrangements may be appropriate for these funds. It should be noted, however, that even in these circumstances at times of stress the nature of the relationship between the manager, the fund governing body and the investors can be tested. It may therefore be the case that a more robust, advanced governance model could be an advantage even for these more informal types of hedge fund.
- At the other end of the spectrum, best practice should reflect the increased depersonalisation, institutionalisation and “retailisation” of the investor base by the fund manager seeking to strengthen the fund governing body and giving more prominence to the distinction and independence between the fund governing body and the hedge fund manager. Such independence may be reflected in the composition of the fund governing body and/or the ability of the fund governing body to terminate the investment management agreement.
- In the case of listed or quoted closed-ended vehicles, this is likely to make compliance with all or substantially all of the provisions of established codes of corporate governance and other director guidance desirable (or perhaps versions of such codes or guidance which have been adapted specifically for hedge funds). An advanced governance model such as this requires a suitably qualified and experienced board with a majority of independent directors who can hold the manager directly to account for its performance and its conduct under the investment management agreement.

Of course, HFSB acknowledges that irrespective of the chosen governance approach, in practical terms, investors usually choose a manager to invest with rather than appointing a fund governing body with a mandate to select an appropriate manager.

The key issue which the HFWG identified in relation to the establishment of appropriate fund governance mechanisms was therefore:

- Do hedge fund managers provide a satisfactory mechanism or vehicle for handling potential conflicts of interest between themselves and investors?

FSA Principles

Relevant FSA Principles in this context include:

- (3) Management and control – a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
- (6) Customers’ interests – a firm must pay due regard to the interests of its customers and treat them fairly.
- (7) Communications with clients – a firm must pay due regard to the information needs of clients and communicate information to them in a way which is clear, fair and not misleading.
- (8) Conflicts of interest – a firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.

Fund governance Standards and Guidance [21]

- **Prior to the establishment of a fund, a hedge fund manager should assess where the fund governance structure should lie on the “spectrum” (see above). In light of that assessment, the manager should be proactive in seeking to ensure that a fund governance structure which is suitable and robust to oversee and handle potential conflicts of interest is put in place at the outset.**
- **A hedge fund manager should on the establishment of a fund do what he reasonably can to encourage and assist the fund governing body to identify and recruit members of the fund governing body with suitable experience and integrity to enable the fund governing body to be able to discharge effectively its role with the appropriate level of independence.**
- **A hedge fund manager should throughout the life of the fund be cognisant of the need for the fund governing body and governance processes to be effective and appropriate (having regard, among other things, to any changes in the nature of the fund and its investors), advise the fund governing body accordingly and do what it reasonably can to encourage and assist the fund governing body to make any changes which in the light of such advice the fund governing body considers to be necessary or desirable (including recommending suitable individuals it has identified as additional or replacement directors as appropriate).**
- **A hedge fund manager should encourage and assist the fund governing body to meet regularly, to conduct such meetings in a manner which safeguards the intended legal, regulatory and tax status of the fund and to document such meetings properly.**
 - In normal circumstances HFSB would expect fund governing bodies to meet at least quarterly.
- **A hedge fund manager should carefully consider the extent to which the adoption by the fund governing body of all or parts of established codes of corporate governance or other director guidance⁵¹ is appropriate and do what it reasonably can to encourage and assist the fund governing body to act accordingly. This includes ensuring that the fund governing body has adequate resources to comply with any such corporate governance code or director guidance.**

Whilst HFSB recognises that managers cannot legally require independent boards to adopt best practice principles for their governance, they should nevertheless use their influence to encourage adoption and compliance. Naturally, HFSB is also aware that the Standards in no way override legal, technical, contractual and tax realities.

As guidance to managers when considering which corporate governance code or director guidance are appropriate for fund governing bodies to adopt, HFSB has set out below a selection of those principles contained in the corporate governance codes and director guidance published by AIC and AIMA which it considers to be of greatest importance⁵¹. HFSB recognises, however, that not all of these principles will be applicable to all types of hedge funds:

- directors’ potential conflicts of interest should be disclosed fully to the fund’s investors (through the fund’s offering documents) and the board as a whole (at the first available meeting) (AIMA 1.4);
- fund boards should have sufficient collective expertise, availability and be otherwise qualified to understand the investment policy and strategies of the fund and the attendant risks (AIC 6, AIMA 1.4). Expertise should include areas such as investment management, regulatory issues, accounting, administration and technical understanding of the fund’s strategies;

⁵¹ AIC: Association of Investment Companies: The AIC Code of Corporate Governance (2007), <http://www.theaic.co.uk/files/technical/AICCode.pdf>; AIMA's Offshore Alternative Fund Director's Guide (2008) www.aima.org (the full text is only available in hard copy).

- the board should put in place a policy on tenure of directors and disclose it in the fund’s offering documents and its annual report (AIC 4);
 - directors’ remuneration should reflect their duties and responsibilities, and the value of their time spent (AIC 8);
 - regular face-to-face board meetings should be held, preferably quarterly (AIMA 1.6). Typical board agendas may include approval of accounts, investment performance review, review of any relevant regulatory breaches and review of the performance of third party service providers such as the administrator and prime broker(s), review of the manager’s risk management procedures;
 - there should be regular review of adherence by the manager to investment policy and investment restrictions, review and approval of side letters, compliance and valuation functions and regular review of business continuity. (AIMA 3.5 provides further detail);
 - the manager, external valuation agent and administrator should be required to report regularly to the fund directors regarding performance, subscriptions, redemptions and adherence to investment policy and restrictions and applicable anti-money laundering requirements (including direct reporting from the compliance officer and any in-house valuation function) (eg AIMA 4.2 and 6.2 and 6.5);
 - the fund directors should be made aware of their personal responsibility for the issuance and legality of side letters or discretionary waivers (AIMA 6.9 and 6.11); and
 - the directors should consider whether the fund should take out D&O insurance proportional to any liabilities relating to the directors’ role with respect to the fund (AIMA 7).
- **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to obtain from the fund's administrator regular reports on compliance with laws and regulations (in particular those relating to anti-money laundering) applicable to activities which are performed by the administrator on behalf of the fund.**

Fund Governance – Disclosure Standards and Guidance [22]

- **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to disclose details of the fund governance structure which is put in place in the fund’s offering documents.**
- This could include elements such as:
- biographies of each director setting out details of his/her experience relevant to performing the role of a member of the fund governing body;
 - an indication as to whether each member of the fund governing body is independent of the hedge fund manager; and
 - details of any corporate governance code or director guidance with which the fund governing body has agreed to comply.
- **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to disclose the existence of any class of shares which are held only by the manager (or an entity connected with the manager) and which carry voting rights affecting any aspect of decision-making in respect of the fund in the fund’s offering documents.**
- Such classes of shares are often known as “founder” or “management” shares and carry rights to, among other things, vote (to the exclusion of any other shareholders) on the appointment or removal of directors and/or the termination of the investment management agreement between the hedge fund and its manager.*

Shareholder conduct, including activism [23]-[28]

Investors who take on a more pronounced role in dealing with companies in which they are invested with a view to encouraging behaviour more beneficial to shareholders are often referred to as “activist” investors. This could include, but is not limited to, engaging in discussions with management on issues such as overall company strategy, capital structure, dividend policy, merger or de-merger decisions and executive compensation. It could ultimately result in the investor exercising its voting power to effect changes that the investor believes will increase the value of its investment in the company.

While the term activism is often used to describe hedge fund managers, it is important to note that an overwhelmingly large number of activist investors are clearly not hedge fund managers, and most hedge fund managers are not pursuing activist strategies. Even if a manager is labelled as being activist, this does not mean that it engages actively with all companies in which it invests.

The HFWG acknowledges that there is a public debate on the advantages and disadvantages of activist investing. Among the perceived advantages are better risk and resource allocation in the economy as a whole and strengthened corporate governance⁵². Perceived disadvantages include short-termism and job losses in corporate restructurings. However, general debate about activist investing is beyond the scope of this report, although the HFWG members would be happy to contribute to it. Rather than engaging in this debate here within this Report, the HFWG believes it is more appropriate to clarify some specific underlying concerns and delineate best practice approaches that hedge fund managers should adhere to in relation to their conduct on behalf of funds which are shareholders in investee companies. Relevant areas include prevention of market abuse, such as insider trading, and other issues relating to shareholder conduct.

It is important to note that the best practice approaches identified in the following sections might well merit consideration for adoption by all investors as well as applying to hedge funds.

The subsequent Standards apply to all hedge fund managers, whether activist or not.

Prevention of market abuse [23]+[24]

Proper market conduct and prevention of market abuse are crucial to maintaining market integrity and overall confidence in financial markets. Of course, market abuse applies to a much wider range of activities than just activism. All market participants, including hedge fund managers, have to comply with the laws and regulations applicable in the markets in which they invest. In the EU context, the relevant legislation is the Market Abuse Directive (“**MAD**”) which has been implemented in the UK by section 118 of the Financial Services and Markets Act 2000 (“**FSMA**”). In addition to the five market abuse offences introduced by MAD, FSMA also contains two market abuse offences retained from the pre-MAD UK regime. The Code of Market Conduct published by the FSA contains guidance on compliance with the market abuse regime.

However, activist investors are much more involved in the interplay of information between the public and private domains than traditional managers and therefore need to be particularly vigilant about market abuse. In addition, hedge funds often span a variety of asset classes including equities, credit and private equity, and may have access to privileged information in certain areas of their organisation. This requires adequate mechanisms to ensure compliance with applicable market abuse laws and regulation.

The HFWG identified the following issue in relation to market abuse:

Do hedge fund managers comply with applicable law and regulation on market abuse?

⁵² Eg see OECD Report on The Implications of Alternative Investment Vehicles For Corporate Governance (2007) <http://www.oecd.org/dataoecd/60/11/39007051.pdf>

FSA Principles

- (1) Integrity – a firm must conduct its business with integrity.
- (3) Management and control – a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
- (5) Market conduct – a firm must observe proper standards of market conduct.
- (11) Relations with regulators – a firm must deal with its regulators in an open and co-operative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.

Prevention of market abuse – Governance Standards and Guidance [23]

- **A hedge fund manager should ensure that it has internal compliance arrangements which are designed to identify, detect and prevent breaches of market abuse laws and regulations.**

A sound approach might include the following components:

- a dedicated compliance officer who is not involved in the investment management process;
- a written compliance document describing all relevant compliance procedures;
- documentation of all compliance incidents by the compliance officer in accordance with, where relevant, applicable regulatory requirements;
- training/education of investment management and other staff to ensure that the relevant laws and regulations, the relevant compliance procedures and what constitutes inside information are all understood and adhered to;
- the provision of regular compliance reports to the fund governing body;
- seeking legal and regulatory guidance to ensure that compliance arrangements are designed to prevent regulatory breaches; and
- open relations with its regulator.

The table over provides some examples of procedures which may support the application of best practices.

Examples of compliance procedures designed to identify, detect and prevent market abuse

Abuse	Procedures
Insider dealing	<ul style="list-style-type: none"> • Notification to the compliance officer if an employee believes he/she has received inside information • Compliance officer to determine whether information is material and non-public • If information is material and non-public, the securities of the issuer concerned are to be placed on the restricted list (in which case such stocks cannot be traded) or on a grey list (non-disclosed restricted list, which prevents such information from being shared with the entire firm, such that it might allow personnel to second guess why something was restricted) • Securities (shares, bonds, etc) of companies on the restricted list in which the entire firm would be excluded from dealing (eg, restricted in the order management system) • Where practicable, Chinese walls to prevent, for example, individual portfolio managers who are members of a creditors' committee of a distressed or bankrupt company (and who therefore have access to confidential information) from also trading such company's debt or equity • In instances where inside information is known to employees who have no active involvement in the investment management function, documentation of details of this knowledge should be placed on a separate (non-publicised) register
Dissemination of insider information	<ul style="list-style-type: none"> • Managers should have policies to restrict dissemination of material non-public information including, for example, the manager's own intention actively to engage with a company (eg by advocating/suggesting a corporate restructuring)
Non-disclosure of shareholdings when disclosure thresholds have been exceeded	<ul style="list-style-type: none"> • Managers should document arrangements with other parties (eg other managers) together with which it has adopted a "lasting common policy towards the management of the issuer in question" • Relevant disclosures should take place if disclosure thresholds are exceeded, accounting for collective share ownership of all parties involved
Prevention of market manipulation	<ul style="list-style-type: none"> • Public relations policies regarding public statements of intent to seek to ensure that no false or misleading impressions are given to the market

Prevention of market abuse – Disclosure Standards and Guidance [24]

- **A hedge fund manager should disclose to investors in its own marketing materials that it has a policy to prevent market abuse (no disclosure of the actual policy is required).**

Further guidance on market abuse topics applicable to a range of firms can be found in FSA Market Watch publications⁵³. The HFWG recognises the complexity of the issues and would welcome further guidance from regulators, as well as being ready to participate in necessary debate.

Examples of potential inside information

- Knowledge of another hedge fund manager's intention to engage in activist behaviour (which is not publicly disclosed).
- Inside information obtained by a manager while serving on a creditor committee in a bankruptcy work-out situation.
- Information on upcoming securities offerings, which have not yet been publicly announced by the issuer.

⁵³ Market Watch No. 15, 17 (Anti market abuse systems and controls); No. 20 (shareholder activism); No. 21 (controls over inside information relating to takeovers): http://www.fsa.gov.uk/pages/About/What/financial_crime/market_abuse/library/newsletters/index.shtml

Proxy voting [25]+[26]

Assets under management by the hedge fund industry have significantly increased over recent years and hedge funds have become powerful participants in equity markets. As part of their duties to their clients, hedge fund managers should participate, where possible, in corporate decisions that affect the performance of investments.

The HFWG identified the following issue in relation to proxy voting:

- Do managers fulfill their duty to vote proxies where it is in the best interest of investors?

FSA Principles

(5) Market conduct – a firm must observe proper standards of market conduct.

(6) Customers' interests – a firm must pay due regard to the interests of its customers and treat them fairly.

Proxy voting – Governance Standards and Guidance [25]

- **A hedge fund manager should have a proxy voting policy which allows investors to evaluate the general approach the manager takes towards proxy voting. A summary thereof should be made available to investee companies on request.**

HFSB envisages that a voting policy might include the following elements:

- guidelines as to the process to be followed to decide how to exercise voting rights, including responsibility to vote and mechanisms to resolve potential conflicts of interest;
- a mechanism to review proposals that are not considered to be in the best overall interests of a company in which the hedge fund is invested;
- a process for deciding when and how to communicate with an investee company's management or board of directors and other shareholders; and
- a process for determining whether to join the efforts of other concerned investors, with due regard to compliance procedures to prevent market abuse (see Guidance in Standard [24] (*Prevention of market abuse*)).

It is acknowledged that prime brokers will often not undertake to notify funds or their managers of corporate events. The proxy voting policy may well state, therefore, that the manager's ability to follow such policy will depend on its being aware of the opportunity to vote.

HFSB acknowledges that it may not be part of a manager's strategy to vote all proxies (eg, "black box" traders⁵⁴) and a manager might, for cost benefit considerations, adopt a systematic approach, for example never voting except in exceptional circumstances, rather than evaluating each proxy situation. In such circumstances, this should be explained to investors in accordance with the comply or explain regime.

54 Black box trader: computerised, automated trading system, which generates buy and sell signals based on proprietary algorithms, often executing a larger number of trades.

Proxy voting – Disclosure Standards and Guidance [26]

- A hedge fund manager's proxy voting policy should be made available to investors upon request. A hedge fund manager should also document cases where the voting policy has not been followed and report accordingly to the fund governing body.

Disclosure of derivative positions [27]

Derivatives such as CfDs allow investors to obtain economic exposure to stocks. There are many reasons for seeking exposure via derivatives rather than buying the stock directly, including market access, stamp tax and funding/leverage⁵⁵. The HFWG is conscious that these derivatives do not normally fall under the same disclosure requirements (in the UK, for example, under the FSA's Disclosure and Transparency Rules⁵⁶) as shares owned outright⁵⁷.

The HFWG identified the following issue on disclosure of derivative positions:

- Do hedge fund managers use derivatives to avoid disclosure of (economic) positions in companies which, if they owned the stock directly, would have to be made public, thereby giving a misleading impression to the market?

FSA Principles

(1) Integrity – a firm must conduct its business with integrity.

(11) Relations with regulators – a firm must deal with its regulators in an open and co-operative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.

Disclosure of derivative positions

HFSB acknowledges that companies have a right to know who owns them or who has an ability to obtain significant voting power easily. Indeed, members of the HFWG would welcome higher levels of disclosure.

However, the voluntary adoption of enhanced disclosure requirements by hedge fund managers (or any other particular sector of the market) would cause distortions in the market place because they would not apply to all market participants but merely to hedge fund managers.

HFSB welcomes the FSA consultation⁵⁸ on the disclosure of contracts for difference and looks forward to its results.

Borrowing stock to vote [28]

Securities lending arises when a holder of securities agrees to provide them to a borrower for a limited period of time secured against pre-agreed collateral or cash. At the end of the lending period, the borrower returns the securities, or an identical equivalent, to the holder. The holder receives a fee from the borrower for the use of the borrowed securities. Since ownership passes to the “borrower”, stock “lenders” lose the right to vote their stock although they retain the economic interest, while the borrower obtains the right to vote.

This has given rise to concern that some market participants could borrow stock in order to vote at shareholder meetings, while not being economically exposed. As a result, the voting rights attaching to the holding would not necessarily be exercised in the best interest of the lender who has the economic exposure. The HFWG is

55 When buying stock, the investor will have to pay the market value of the holding. In the case of a derivative, the investor might only be exposed to the changes in value of the underlying stock, but with no need to fund the position at the outset, save for the posting of margin.

56 Disclosure and Transparency Rules, eg requiring disclosure of share ownership if certain thresholds are exceeded.

57 NB: There is a disclosure obligation if under the terms of the derivative the fund can require physical delivery of the underlying securities.

58 FSA's Consultation paper 07/20 "Disclosure of contracts for difference" (November 2007): http://www.fsa.gov.uk/pubs/cp/cp07_20.pdf

concerned that this use of borrowed stock undermines investor confidence in the results of shareholder votes. Since this issue is not specific to hedge funds but is of wider application, the HFWG would welcome wider consultation with regulators and market participants to develop a regime that is applicable to all parties and ties votes to underlying economic exposure.

The HFWG identified the following issue on borrowing stock:

- Is it appropriate for hedge funds to borrow stock to vote while not economically exposed?

Borrowing stock to vote – Governance Standards and Guidance [28]

- **A hedge fund manager should not borrow stock in order to vote.**

HFSB acknowledges that there might be specific situations where it should be acceptable to vote on borrowed stock, eg when a fund is invested in shares (and the trade has settled), but the shares have not transferred into their name.

Acknowledgement of legal firms

The HFWG would like to thank Herbert Smith LLP for legal counsel and major help in drafting and refining the Standards. The HFWG would also like to acknowledge the valuable contribution to the refinement of the Standards made by Simmons & Simmons and Dechert LLP. The HFWG hopes that the work put into the Standards by these three firms will facilitate their widespread and early adoption by the hedge fund community.